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TAGS: ECON EFIN PREL PGOV CH
SUBJECT: PREMIER WEN'S COMMENTS ON U.S. TREASURIES: PROTECT CHINA'S INVESTMENTS

REF: BEIJING 0666

Classified By: Economic Minister Counselor Robert Luke; Reasons 1.4 (b, d)

Summary

¶1. (C) Since Premier Wen Jiabao's March 13 remarks at a press conference that China was "concerned" regarding the security of its U.S. Treasury holdings and other investments (ref), other Chinese contacts have clarified and interpreted his comments. At the G-20 ministerial meeting in London, the head of the State Administration of Foreign Exchange (SAFE) and Deputy Central Bank Governor noted continued Chinese concerns about the inflationary implications of the expansion of the Fed's balance sheet. In a meeting that preceded Wen's remarks, SAFE Director General (DG) Yin Yong noted SAFE's concerns about the potential for U.S. dollar depreciation and U.S. inflation, as both would erode the renminbi (RMB) value of their assets. On March 19, DG Yin told us that Premier Wen and other senior leaders believe it is important to avoid actions that could be perceived as adversely impacting the claims of senior creditors to systemically large financial institutions and to avoid a repeat of "(the) Lehman (situation)" in 2008. MOF Assistant Minister Zhu Guangyao said that enhancing confidence and trust should be an important theme of the next Economic Dialogue. Other Chinese contacts have offered similar versions of their Government's concerns, with one noting that there has been a "huge debate" within the government about China's holdings of U.S. Treasuries. See comments in paragraphs 8-10. End Summary.

¶2. (U) At the March 13 closing press conference of the National People's Congress (NPC) in Beijing, Premier Wen Jiabao was asked about U.S. measures to counteract the global financial crisis in light of China's large holdings of U.S. debt, and also about China's strategy to spread investment risk if the USD depreciated. In response, Wen said China was "paying close attention" to the U.S. economic situation and the USG's measures to address the crisis. He then added that "we are certainly concerned about the security of our assets" and "I am a little concerned." Following the press conference, coverage of Wen's remarks by China's official Xinhua news agency acknowledged the Premier's "worries" while also reporting that Wen expected U.S. measures would "counter" the crisis. Xinhua also noted that China's reserves were "generally safe" (ref).

What Did Wen Mean?

¶3. (C) Wen's remarks immediately generated intense speculation that China might be contemplating some adjustment in its foreign reserve management policy. Shortly after reports of the Premier's remarks became public, U.S. Treasury

Department Acting Assistant Secretary Sobel raised the issue with State Administration of Foreign Exchange (SAFE) Director (and People's Bank of China Deputy Governor) Hu Xiaolian. (Note: SAFE is the Chinese government agency responsible for managing China's reserves.) In response, Hu noted China's continued concerns about the inflationary implications of the expansion of the Fed's balance sheet; her comments closely paralleled those conveyed by SAFE Director General (DG) for Reserve Management Yin Yong during a February 26 meeting in Beijing with visiting U.S. Treasury DAS Dohner. On that occasion, Yin had observed that SAFE was concerned about the risks of U.S. dollar depreciation and U.S. inflation, as both would erode the RMB value of their U.S. dollar denominated assets. Yin called President Obama's announced intention to cut the federal budget deficit by the end of his first term a wise step, and said he would like to see measures by the Federal Reserve to unwind its injection of liquidity after the financial crisis ends.

Stabilize the Economy, and Protect the Investors
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¶4. (C) In a March 19 follow-up conversation with Finatt, SAFE DG Yin, who clearly had deferred meeting with us until he received approval and guidance from his superiors, said the Premier had been "worrying" about all of China's investments in the U.S., including U.S. Treasury securities. Wen also had "noticed" the policies promulgated by the administration of President Obama, and hoped that the measures taken to address the global economic crisis would help to stabilize the financial systems and promote economic recovery. Yin also said his "understanding" of Premier Wen's message was, in addition to the above objectives, that U.S. policy should

focus on protecting the interests of investors, as both financial stability and protecting investor rights were important for strengthening the confidence of domestic and foreign investors.

¶5. (C) Continuing, DG Yin said he believed the USG measures taken thus far are "responsible" and he hoped any future interventions in systemically large financial institutions also would be responsible and consistent. Ensuring that would be vital for maintaining investor confidence, while anything harmful to confidence would also undermine financial stability. Yin noted concern about "voices" in the U.S. -- but not in the Obama Administration - that were recommending "sacrificing" the interests of some senior creditors' claims on systemically large financial institutions. (Comment: Some U.S. commentators have suggested that the U.S. government require that senior creditors take "haircuts" as a condition for intervening in U.S. financial institutions. In previous cases where the FDIC took over insolvent banks, not all creditor claims were honored in full). After Finatt observed that USG interventions taken to date in large financial institutions have for the most part been designed to maintain the confidence of holders of senior debt, Yin replied that U.S. policies should be consistent, "not like Lehman" in
¶2008. (Comment: Several interlocutors have told us that Lehman was a counterparty to SAFE in financial transactions and as a result SAFE suffered large losses when Lehman collapsed.)

Huge Internal Debate

¶6. (C) Other Chinese contacts have offered us similar versions of their Government's concerns about its U.S. investments in recent weeks. In a February 27 meeting with visiting Treasury DAS Dohner, senior economist Shen Minggao of the respected "Caijing" magazine said there has been a "huge debate" within the government about China's holdings of U.S. Treasuries. Some officials are concerned about the risks of future U.S. inflation due to excess liquidity creation and USD depreciation. Furthermore, if China buys more, the risk grows. He understood that SAFE has been shifting its portfolio toward shorter-term assets to reduce

the risk of capital losses from higher inflation. Shen also recommended the USG consider entering a bilateral agreement with China under which China would continue providing funds to the U.S. in exchange for some sort of hedging scheme.

¶7. (C) On March 18 Director Xiao Lian of the Center for American Economic Studies at the Chinese Academy of Social Sciences (CASS), told us that Premier Wen and the senior leadership have been under "strong pressure" to address public criticism about recent high profile losses on China's overseas investments. Xiao also speculated that Wen may have wanted to reiterate China's concerns, perhaps more clearly understood by former Secretary Paulson and other now-departed U.S. officials, to the new Obama administration. On March 16, CASS researcher Zhang Ming speculated to us that China may want to invest in Treasury Inflation-Protected Securities (TIPS) or RMB-denominated assets, to protect its overseas investments. Professor Yu Yongding, also of CASS and Director Xiao Lian's superior, has long advocated that China press the U.S. to issue RMB-denominated debt, and at a recent conference Yu opined that China should receive equities in U.S. nationalized banks as collateral for its U.S. investments. Xiao told us he has proposed that the U.S. Government issue convertible bonds that Chinese investors could convert into stocks (presumably of financial institutions held by the U.S. government).

Comment

¶8. (C) Regarding Premier Wen's remarks at the NPC press conference, comments of this nature by senior Chinese leaders, both public and private, are not new, although they have not been expressed so directly at such a senior level. Last fall on numerous occasions, Vice Premier Wang Qishan remarked to then-Secretary Paulson, both privately and during the public session of the Strategic Economic Dialogue, on the need to "protect" Chinese investments. Since then, officials from SAFE have repeatedly noted concerns about the risks of an adverse market reaction, in both the fixed income and foreign currency markets, to upcoming large gross issuances of U.S. Government securities and the Federal Reserve's injections of liquidity. (Comment: the U.S. dollar dropped significantly against major currencies following the Federal Reserve's announcement that it would be increasing

significantly its purchases of various U.S. fixed income instruments, including long-term U.S. Treasury bonds).

¶9. (C) Comments of this sort do not imply that China will attempt to dump its U.S. Treasury holdings. Rather, they indicate that China's leaders are aware that, while they can purchase more or fewer USD-denominated assets at their margin, their holdings are so enormous that they cannot reallocate the currency composition of their portfolio to any meaningful extent without leading to large capital losses and thus further public -- and internal -- criticism.

¶10. (C) We believe Wen's remarks were most likely intended to acknowledge rising public criticism over the government's losses on its investment of reserves (fueled by high-profile losses by the China Investment Corporation (CIC) in Blackstone and Morgan Stanley). Wen also probably intended to maintain blame for China's current cyclical downturn on foreign factors, urge the U.S. and others to act resolutely to restore financial stability and to stem the decline in financial assets; signal to western governments that when intervening in financial institutions not to trample on the claims of foreign investors (e.g., as was done to China's Ping An insurance company with its investment in Belgium's Fortis); and, avoid surprises that could adversely impact the claims of senior creditors. Ironically, one of the largest USG interventions in financial institutions to date was in Freddie Mac and Fannie Mae, where it agreed to inject up to USD 400 billion in capital to keep the institutions solvent. As former Secretary Paulson noted, this "effectively

guarantees" claims of senior creditors, the largest of which is most likely SAFE.

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